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260938Z Jul 05

UNCLAS SECTION 01 OF 02 PARIS 005141

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SUBJECT: 2005 NOT A GOOD VINTAGE FOR FRENCH GDP GROWTH

Ref: Paris 4565

1. SUMMARY. The National Statistical Agency's forecast confirmed that the 2005 GDP growth is likely to be modest, close to 1.5% -- lower than the 2% government forecast, despite an expected recovery in the second half of the year. The agency sees a high risk of sluggish economic growth among France's European partners. The agency forecast that the unemployment rate would decrease to 9.8% by the end of the year (down from the 10.2% current level), as a result of new government measures to promote employment. END SUMMARY.

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INSEE Forecast GDP to increase 1.5% in 2005  
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2. In late June, the French National Statistical Agency (INSEE) forecast a GDP increase of 1.5% in 2005, shaving half a point from Finance Minister Thierry Breton's projection (reftel). INSEE analysts stressed that rising oil prices and lackluster demand from France's European partners caused an economic slowdown in France in the first half of 2005.

3. GDP growth is forecast to accelerate to 1.6% (annualized) in Q-3 and 2.4% in Q-4, representing an increase from 0.8% in Q-1 and 1.2% in Q-2. A decrease in oil prices to USD 45 is expected to slow inflation (1.5% in December from 1.7% in May), boosting households' purchasing power and consumer spending (which accounts for more than half of GDP) in the second half of the year.

4. INSEE forecasts a recovery in exports in the second half, scaling back its euro exchange rate prediction to 1.25 USD from 1.30 USD in its previous forecast. Analysts expect exports to euro zone partners to stagnate due to the fact that euro zone economic growth has been slowed by sluggishness in Italy and Germany. Euro zone economic growth is not predicted to be more than 1.3% in 2005. Despite the improvement in the second half, export growth should slow from 2.4% to 1.9% in 2004.

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Labor Market Remains Weak; GOF Wants to Move Quickly on Measures  
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5. INSEE's Chief forecaster, Michel De Villiers, stated that the French labor market remained weak in the first half of 2005. Hiring is expected to slow this year due to reduced job creation in the private sector (30,000 new jobs, after last year's 40,000). Nonetheless, employment could stage a rebound (adding as many as 130,000 new jobs) near the end of 2005 due to government measures (reftel), which could have the potential to reduce the unemployment rate to 9.8% from its 10.2% current level. Nevertheless, the French unemployment rate remained stuck at 10.2% in May for the third consecutive month.

6. The Government wants to move quickly on emergency measures to encourage employment by requesting authorization from the Parliament to use "ordonnance" procedures for two months. Ordonnance procedures will allow the government to amend labor laws without requiring controversial legislative up or down votes. The National Assembly passed the bill granting the GOF "ordonnance" powers for urgent employment measures on July 5. However, senators passed amendments to reinstate protections for employees laid off before the end of their contracts. The bill will extend the probation period from several months to two years - during which very small businesses may fire workers without extended notice and administrative proceedings. A joint commission composed of deputies and senators reconciled the two versions of the bill and it was formally adopted on July 13.

7. When asked about the difference between INSEE's and the government's 2.0% forecast, De Villiers said: "It seems to

us that in the current circumstances, and in light of what we expect in the second half, it's difficult to go beyond 1.5% (growth) in 2005." INSEE singled out sluggish economic growth in continental European economies as the main obstacle to French economic recovery. Nonetheless, INSEE did not rule out the negative impact of an increase in oil prices, saying that oil prices of USD 60 per barrel would further cut 2005 GDP growth to about 1.3%.

18. De Villiers indicated that a cut in the European Central Bank interest rate (below 2%) might provide a psychological fillip since "companies in the region are tense, a gesture would relax them," but such a move would not have a direct and immediate positive impact on the French economy.

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Upward Revision to Q-1 GDP Growth Slightly Boosts Annual Figure  
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19. On June 30, after publishing its forecast, INSEE revised upward Q-1 GDP growth from 0.8% to 1.3% (annualized). Based on our calculations, this revision raises INSEE's 2005 GDP growth forecast to 1.6% from 1.5%. Meeting the 2.0% government target requires an average of 2.0% annualized growth per quarter in the last three quarters.

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GOF Sees Better Outlook for 2006  
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110. De Villiers stated that GDP growth might accelerate to 2% in 2006, but was less optimistic than Budget Minister Jean-Francois Cope. In an interview with Radio J on July 3, Cope predicted that the French economy would grow 2.25-2.75% in 2006. However, he said "all this is a bit uncertain, it is too early in 2005" and further warned that "the major negative factor is the price of oil." He reiterated that the government will be "in position" to keep its budget deficit under 3% of GDP in 2005", despite weaker-than-expected GDP growth (based on recent government downward revision to 2%).

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COMMENT  
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111. GDP growth of 1.5% in 2005 would make it even more difficult to tackle the bloated budget deficit. INSEE's forecast confirms that 2005 economic growth will only be modest, taking into account the persistence of structural problems. With the 2007 presidential elections in mind, the Government has chosen to subsidize job creation, rather than press for economic reforms to address structural causes of unemployment.

STAPLETON